

SPECIAL AGENT IN CHARGE

SEVENTH REPORT

Washington State Light Control
Board

**DEFENDANT'S
EXHIBIT**

CASE
NO. C04-0360P

EXHIBIT
NO. 426

Resp to Costco RFP
2091

TX426-001

WASHINGTON STATE LIQUOR CONTROL BOARD

Report of Operations

OCTOBER 1, 1939, TO SEPTEMBER 30, 1940

The Board's Seventh Annual Report of Operations covering the twelve months ended September 30, 1940, is submitted in accordance with the requirements of section 72 of the Washington State Liquor Act. Comments are contained herein on the effects of the changes made during the last session of the legislature. Although some of these changes were commented on in the Board's Sixth Report, they only became fully effective during the year under review and certain comments from last year's report are repeated for the sake of completeness.

Administration of the Act

The Washington State Liquor Act provides for strict control of the liquor industry under a single state administrative agency and provides the administrative body with broad powers to meet emergencies and changing conditions as they occur. The Board has kept before it constantly the mandate that the Act be so administered as to promote true temperance and to eliminate the evils which surrounded the liquor traffic in prior years.

Under our democratic form of government, the broad powers granted the Board by the Act as originally written will only be allowed to remain in effect so long as they are administered with all possible fairness. In its administration, the Board has constantly striven to follow consistent policies with regard to its licensing and merchandising operations. At the same time the Board has from time to time changed certain policies to some extent to meet changing conditions. The advisory liquor commission which drafted the original act proposed a very liberal policy for beer licenses and a small margin of profit in the merchandising operation. Actual operations of the Board proved that a too liberal licensing policy resulted in lax and undesirable operations on the part of licensees because of competitive conditions. Consequently, the Board put into effect a more restrictive licensing policy which has steadily reduced the number of licensed premises and the operations of those remaining have materially improved.

The advisory commission proposed a low margin of profit in the merchandising operations to eliminate illicit liquor. This was done. Illicit liquor was quickly eliminated from the state and today only a small fraction of one per cent of the liquor consumed in this state is of illicit origin. At the same time it became apparent that the added social services demanded by the people from the state and local governments required additional revenue. It was clear that liquor should carry as great a proportion of this load as possible providing the evils of illicit trade were not brought back into existence. Consequently, the margin of profit on merchandise operations has been steadily increased over the years. This was done by the Board directly in all cases except for the 10% sales tax which is included in the prices shown in the Board's price lists and which was enacted by the 1935 session of the legislature. During the first year of the Board's operation, the average gross profit amounted to 21.5% of sales, while the average gross profit during the last year amounted to 41% (taking into account the 10% sales

tax). At the same time, it should be borne in mind that Federal taxes on liquor have also been increasing.

The Board has always been of the opinion that the "10% sales tax" imposed by the 1935 session of the legislature is an unwise provision. The effect of the state taxing its own business merely adds useless and expensive bookkeeping entries and confuses the income statement for the ordinary reader so that the details of operation are not clear without raising any additional revenue that could not have been procured directly by the Board. The only practical effect of the provision was to increase the distribution of liquor revenue to the state at the expense of the cities and counties, with the further result that the last session of the legislature reallocated the revenues to the benefit of the cities and at the expense of the state, thus practically offsetting the original effect of the 10% sales tax.

The Board is firmly of the opinion that the present liquor act is on the whole one of the finest pieces of liquor legislation ever devised. The broad principles contained in the Act appear to have met the approval of the great majority of the people of the state, while the flexible nature of the detailed provisions carrying out these broad principles has enabled the Board to administer the Act efficiently and without losing sight of the primary purposes of the Act. Experience shows that to be successful revenue should be subordinated to control.

Revenues

The sales in the Board's stores and agencies increased from \$14,336,909.97 during the previous year to \$14,844,815.34 for the fiscal year under review. At the same time profits from merchandising operations increased from \$3,728,477.11 to \$4,289,454.45. Net revenues from the Board's licensing operations were practically constant amounting to \$1,168,223.21 for the year ended September 30, 1940, as compared with \$1,152,411.33 for the previous year. The 10% sales tax is not included in these figures and amounted to \$1,484,206.86 while the 2% sales tax yielded an additional \$310,495.61. During the year under review, the Board distributed out of profits \$5,250,000. Since the start of its operations in February, 1934, the Board has distributed out of profits and tax collected more than \$32,000,000.

Consumption of Alcoholic Beverages

During the year under review the sales of spirituous liquor in gallons was almost identical with the previous year. The sales of wine through state stores and agencies fell off 10% but this was more than offset by the increased sale of Washington wines so that total wine sales increased about 2%. At the same time the sales of beer in the state showed an increase of approximately 8%. The Board is of the opinion that the increased consumption of beer and wine sold through licensed outlets was largely due to improved purchasing power of the people. The Board is also of the opinion that there was no corresponding increase in the sale of spirituous liquors and a decrease in wine sales in the Board's stores and agencies because of the price increases on these items due to the increase in Federal taxes and increases in the Board's mark-up or profit.

Early in the year 1939, it became apparent that additional revenues were needed for city and state government. The Board on its own volition put an additional mark-up of 10% on its store and agency sales. This did not

yield an additional 10% revenue because the increased prices resulted in a reduction in the sale of wine and a marked tendency by the purchasers of spirituous liquor to turn to less expensive items than they had formerly been in the habit of purchasing. This tendency was further continued during 1940 when an increase in Federal taxes became effective. To date the Board has been unable to detect any noticeable increase in the sale of illicit liquor although there has been some increase in the importation of liquor by consumers from neighboring states where prices are somewhat lower.

The Board feels that further increases in price will yield smaller and smaller increases in revenue. However, if it becomes apparent that greater revenues are required from liquor, the Board will naturally cooperate as in the past and suggests that it be allowed to put such increases into effect itself so that the Board will be in position to make adjustments if illicit operations become serious.

Personnel

At the beginning of the fiscal year the Board had 405 regular employees and 129 agents. During the year 46 regular employees resigned, 5 took military leaves of absence, and 14 agents resigned; while 51 regular employees and 18 agents were appointed. In addition, two regular employees were made agents and one agent was transferred to a store. These changes resulted in a total of 404 regular employees and 134 agents at the end of the year.

EFFECT OF LEGISLATIVE CHANGES

Domestic Winery Licenses

The 1939 legislature changed the wine license provision from a flat fee of \$5.00 per annum in the case of domestic wineries and \$25.00 per annum in the case of other (commercial) wineries, and put the same upon a graduated scale to be computed only on the gallonage manufactured. The new scale runs from \$15.00 for 2,500 gallons or less to \$250.00 for 200,000 gallons to 500,000 gallons, with an additional fee of \$150.00 per year to be charged for each 500,000 gallons or fractions thereof over 500,000 gallons.

Wine Agent's License

The provision of the law which required that all agents for brewers or beer wholesalers contacting licensees of the Board should be licensed at a nominal fee of \$2.00 per annum, was extended to include wine salesmen. As in the case of brewer's and beer wholesaler's agents, the licensing of wine agents at a nominal fee has served to place greater responsibility upon the agents and has been helpful in eliminating violations.

Changes in Domestic Wine Statutes

The legislature changed section 24-A in two respects. The first change was to include a definition of the term "domestic wines," so that the same meant "wines manufactured or produced within the State of Washington in a licensed winery from fruits or fruit products grown exclusively and entirely within the State of Washington."

The second change authorized domestic wineries to sell their products to licensed domestic wine wholesalers or to other licensed domestic wineries,

and exempted from the ten cents per wine gallon tax wine sold or shipped in bulk from one domestic winery to another domestic winery.

Another change was made in section 45, which brought the labeling requirements of the Act in line with Federal requirements.

Enforcement

The legislature changed section 70 of the Act so as to provide the Board with enforcement power instead of requiring the Board to notify the State Patrol or local authorities when enforcement of the Act became necessary. The Act originally provided that the enforcement of the criminal provisions was the sole duty of local enforcement officials. However, the Board had found it necessary in certain areas where peace officers ignored their responsibility of investigation and prosecution, to carry on a certain amount of enforcement work in fairness to the licensees who were operating within the law and also because the general public looked to the Board rather than to local officials when flagrant violations were evident. This change in the Act has enabled the Board to carry on such enforcement activities as appear essential in its own name rather than by deputizing its investigators under the Washington State Patrol. The Board has found the situation more satisfactory now that it has direct authority.

The legislature also enacted an abatement statute (Sec. 33-A) which gave to the prosecuting attorneys the power to abate any building, etc., in which the illicit sale of liquor was being carried on, also giving to the judge who heard the case the right to allow the premises to remain open upon the posting of an adequate bond. The abatement statute has been of some assistance in eliminating certain places which in the past had continued to operate despite frequent prosecutions.

Brewers', Domestic Wineries' and Licensed Beer Importers' Responsibility

The legislature also enacted section 27-D of the Act, which made every licensed brewer, domestic winery and licensed beer importer responsible for the conduct of any wholesaler when handling the products of such brewer, domestic winery or licensed beer importer, and gave to the Board the power of placing additional penalties against the brewer, domestic winery or beer importer. Prior to the enactment of the law, brewers, beer importers, and domestic wineries generally assumed the attitude that after the distributors purchased the product, it was the distributors' own responsibility as to whether or not they violated the liquor law or regulations of the Board. However, since the enactment of this law, the manufacturers and importers realize that if they aid a distributor financially or otherwise with the thought that such aid will be passed along by the distributor to retail licensees, the Board may in its discretion prohibit the sale of the brands involved in any given sales territory. The Board also in its discretion may even restrict the sales in given territories where the manufacturer and importer knows, or should have known, that the distributor is engaged in violative practices. The Board has found that violations on the part of distributors have been reduced due to the enactment of this new law.

Price Changes

The legislature also changed section 4 and section 78 of the Act so as to permit the Board to make a greater profit than had been permitted previously, and also changed the method of distribution. The first of such changes was

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to raise the maximum amount of profit from 25% to 35%. The second method was to provide that funds available for distribution should be distributed 35% to the general fund of the state, and 13% to the counties of the state, and 52% to the incorporated cities and towns of the state, instead of 50% to the general fund of the state and 50% to the counties and incorporated cities and towns of the state.

Change of Penalty

Section 92 was also amended by deleting the fourth subdivision of the old law. This subdivision, which provided a graduated penalty, was not adhered to by the courts.

ADVERTISING

On September 9, 1937, the Board sent to all liquor advertisers, advertising agencies, and advertising media, a revised advertising circular entitled Advertising Circular No. 2. In publishing this circular, the Board in the first paragraph thereof made the following statement of policy:

"Prior to the adoption of the rules and regulations effective October 1, 1937, the Board held conferences with various groups affected, and in the matter of advertising, various advertisers, advertising agencies and advertising media indicated a desire to be allowed to continue under a self-imposed program rather than to be subjected to rigid regulation. In view of this, the Board decided that at the present time, the advertising regulations as such would be kept at a minimum, and that suggestions and recommendations supplemental thereto would be sent to all persons or groups affected. "This circular is now published for that purpose."

In this circular, after making this statement of policy, the Board set forth a number of suggestions and recommendations, such as that liquor advertising should not contain illustrations of women or children, or illustrations depicting the consumption of liquor, or claims of health-giving properties.

So well have all advertisers, advertising agencies, and advertising media cooperated with the Board that no changes in the Board's advertising policy have been deemed necessary since the time of publication of the Board's Advertising Circular No. 2.

With respect to the suggestions and recommendations set forth in the circular, as distinguished from the policy represented by the circular, certain changes were made on September 1, 1940. These changes were brought about not so much by a need for change as by a desire on the part of the newspapers of this state and of the state of Oregon to bring the liquor advertising rules of the two states more closely together. Since the newspapers of the state had given cooperation to the Board in their policy of self-regulation, the Board was glad to reciprocate, with the result that this Board, the Oregon Liquor Control Commission, and the newspapers of the two states formulated and adopted, on September 1, 1940, a set of newspaper advertising restrictions common to both Washington and Oregon. These restrictions include, as far as Washington is concerned, practically all of the old rules, together with a number of restrictions already a part of the Oregon advertising regulations, and several restrictions new to both states.

The Board is appreciative of the spirit of cooperation shown by the advertising agencies, the newspapers and magazines of the state, the outdoor advertising concerns, and the radio broadcasting stations in dealing with the problem of liquor advertising. None of these media are subject

for blending and sale out of the state, leaving a balance of 41,121.8 gallons under seizure at the end of the fiscal year.

Two hearings were held involving domestic wineries. In one instance the winery was given a 15-day suspension with the provision that the suspension would be vacated on payment of a monetary penalty. The other hearing is still pending. Several wineries were required to re-label one or more of their wines because the contents did not conform to statements made on the label.

Price Postings by Domestic Wineries

Shortly before the beginning of the 1940 fiscal year, the Board after careful consideration decided to establish a regulation requiring the filing of price postings by domestic wineries. Evidence submitted to the Board indicated that the domestic wine market was being considerably upset. Prices to wine retailers fluctuated from day to day and it was practically impossible to establish violations. Under the price posting regulation each winery is required to sell its products to wine retail licensees of the Board at the prices on file with the Board and any domestic wine wholesaler handling the products of one or more wineries was required to sell said wine to wine retail licensees at the prices posted by the wineries. The domestic wineries are free to post any prices they desire, but the regulation does require that they do not deviate from the prices posted and in effect. Such prices may be changed at any time by the wineries, but ten days must elapse between the time a change in prices is actually filed with the Board in Olympia and the day the change becomes effective.

Under this regulation, domestic wine wholesalers are relieved of the responsibility of posting prices on wine with the Board. However, the Board does require under a companion regulation that every domestic winery file with the Board a copy of every written contract and a memorandum of every oral agreement which the winery may have with any domestic wine wholesaler which relates in any way to the sale, transfer or delivery of wine by the winery to the wholesaler.

Important Development of the Domestic Wine Grape Industry

As the domestic wine industry in this state has developed, it is of particular importance to note that the production of grape wine has played an important part. Figures were first compiled in 1938 showing the sale of domestic wine in the state by type. This compilation has followed each year and shows that the sale of grape wine led all other fruit or berry wine in 1938, 1939, and 1940. During the 1938 fiscal year, 3,639,684 pounds of grapes were used in the production of wines and brandies; 6,077,200 pounds of grapes were used during the 1939 fiscal year; 8,004,167 pounds of grapes were used during the 1940 fiscal year. For the first time since the domestic winery setup was created, more grapes were used in 1940 in the production of wine and brandy than any other fruit or berry.

The state generally is well adapted for the growing of wine grapes, and it has been found that on the eastern side of the Cascade Mountains certain areas are especially well adapted because of the soil and climate for the growing of European types of grapes. A large proportion of the grape wine produced in this state is made from native types such as the Concord and Island Belle,

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which are grown successfully in both Eastern and Western Washington. However, in the Yakima Valley, and a few other localities, are to be found vineyards of foreign wine grapes—Muscats from the banks of the Nile; Csaba, or Hungarian Muscats; blood-red Alicante; the Zinfandel; the Red Gutadel, native of Saxony; the Johannesburg Reisling, the Black St. Laurent, of Northern France, and vineyards of many other foreign types. It takes years to develop vineyards and as more are planted the domestic wine grape industry will become increasingly important.

The consuming public wants high quality wines made from the best grapes procurable. It will take several years to really develop the wine business as it should be developed in this state. One of the vintners in the Yakima Valley, realizing that the soil and climate is especially adaptable for the growing of grapes, has done much research work and experimenting with the result that he found that European types of grapes will grow as well as, if not better than, they do in their native localities. He is pioneering the wine industry here on a fundamentally sound basis, building for the future, and is to be commended for his efforts. Others will undoubtedly reap the benefit of this research work, especially in view of the fact that there is a great potential wine growing territory lying within the Rosa and Coulee Irrigation projects.

This state has always been famous for the production of fruits and berries; many of these products are used by the wine industry. Loganberries especially are playing an important part in the development of the state's wine industry. Loganberry wine has held second place in state sales during 1938, 1939 and 1940 and has led all other wine in out-of-state sales.

The domestic wine business is developing into one of the important industries in this state. Growers of grapes, berries, and other fruits used in the production of wine are receiving excellent prices for products which were hardly salable prior to the operation of domestic wineries. Many people are regularly employed, the property value of domestic wineries is steadily increasing, and allied industries have greatly benefited from the phenomenal growth of the domestic wine industry.

The Board is continually carrying on its policy of urging domestic wineries to produce wines of the highest quality. Its field representatives and chemists in the laboratory consult almost continuously with vintners in the state, assisting them in eliminating troubles which arise in the manufacture of wine. The closest cooperation exists between the Board, the State Department of Agriculture, Federal authorities, the University of Washington's Bureau of Industrial Research, and the Washington Wine Council.